TAXTALK

U.S. State Tax Considerations for Canadian Businesses

The U.S. market represents a huge opportunity for Canadian businesses to sell their products and/or to expand their business operations. Entering the U.S. market brings with it many U.S. federal and state tax issues, filings and tax obligations. U.S. State tax rules are complex and hard to keep on top of because each state has its own rules and operates differently for each type of tax.

This article outlines the general guidelines of U.S. state taxation for income and sales tax and the application of the rules for each type of tax.

Nexus

In order for your business to be subject to taxation in a particular state or states, that business must have Nexus with the state(s). Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. A simple business connection to, or presence in a state, may be sufficient to subject that business to state taxes. This is generally the minimum standard. Once this level is met, the state may be able to tax the business for income tax and/or sales tax. The Nexus rules are different for each state and each state has their own minimum standards of business activity or connection needed to create Nexus.

Generally, a physical presence in a state is enough to create Nexus in that state. Depending on the state, this is defined as a physical location in a state such as an office or a place of business, employee(s) in a state, inventory and/or fixed assets within the state. Until this connection is established, a state cannot impose income or sales tax on your business.

The Nexus rules have expanded over the years to include:

- **Affiliate Nexus.** An out-of-state business establishes affiliate Nexus in a state when an in-state business receives a commission for referring a certain amount of sales to the out-of-state seller. For example, through a web-site link.
- **Agency Nexus:** If your out-of-state business works with agents or third party representatives to perform services on your company's behalf in a state other than your state.
- **Economic Nexus:** A strong economic presence within a state, such as volume of sales or number of transaction or a combination of both creates Nexus for your company.

Filing Requirements for Income Tax

Nexus is typically created for income tax purposes if your business has sales in a state or an office, employees, inventory, and/or fixed assets in the state.

If your business has Nexus for income tax in a state, then your company will have to file an income tax return in that state. The starting point for state income tax is federal taxable income. Federal taxable income is adjusted based on the state's income tax rules to arrive at state taxable income. Assuming that your business is operating in multiple states, then the state's taxable income is apportioned and allocated based on a weighted average of sales, payroll, rent, and fixed assets in the states. Each state's income tax rate is then applied to the apportioned taxable income to arrive at the state's income taxes payable.

The Nexus requirement for imposing income tax comes from the U.S. Constitution. In this regarding, there is a federal law called the Interstate Income Act or Interstate Commerce Clause or Public Law 86-272 (P.L. 86-272), that protects some sellers from income tax in a state(s). P.L. 86-272 applies when a seller's only activity in the state is soliciting orders for sales of tangible property and where the orders are approved, filled and shipped from outside the state.

Generally, Canadian companies are be protected by this federal Commerce Clause (P.L. 86-272) if they are only soliciting orders in a state.

You should note that P.L. 86-272 does not apply to services. Also most states do not follow the provisions of the Canada-U.S. Income Tax Treaty.

Filing Requirements for Sales Tax

The Nexus threshold for sales tax in much lower than for income tax. As with Nexus for income tax, each state has different rules for sales tax.

Sales tax Nexus defines the level of connection between a state or taxing jurisdiction and a business. Until this connection is established, the state cannot impose sales tax on your business. To date there are about 45 states that have some kind of sales tax. The sales tax rates varies from 1.76% to 9.56 %. The tax is imposed on the buyer, but the seller must collect and remit the tax to the state(s).

Online and Other Remote Retailers

In 2018, the U.S. Supreme Court issued a ruling in the case of South Dakota v. Wayfair et al, where the Court replaced the "physical presence' Nexus rule with a new standard for determining when states can impose a sales tax collection responsibility on out-of-state (including Canadian) sellers of taxable goods and services.

In that case, the Court determined that the threshold for a state to exercise its taxing power is now "substantial Nexus" in the state. However, the Court did not provide a "bright-line" test for the minimum dollar amount or number of transactions that would satisfy the substantial Nexus standard.

The impact of this Court ruling has dramatically changed the U.S. sales tax landscape. Many states are now able to collect sales tax from online retailers, provided that they meet criteria determined by each state. Note that these rules may apply to Canadian online retailers in which case these retailers will have to register and pay sales taxes on products sold into the state(s).

In addition, many states are looking at ways of taxing digital goods and or/or digital services with each state approaching it with different rules. We will monitor these developments and will inform you accordingly.

Summary

Nexus for income and sales taxes are different for each tax and for each state. The Nexus rules for sales taxes are much broader than that for income taxes. Many states already have rules to tax online or remote retailers. Many states also are looking to ways to tax digital goods and/or services.

If you have any questions, please contact your McCarney Group, LLP tax advisers.

Offices: First Canadian Place
100 King Street West, Suite 5700
Toronto, Ontario M5X 1C7
Phone: 416-362-0515

1900 Minnesota Court, Suite 116
Mississauga, Ontario L5N 3C9
Phone: 905-451-4788
Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com). Please visit our web site at www.mgca.com.

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